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SUBJECT: IMF MISSION SHARES POSITIVE BRIEF WITH SKEPTICAL DONORS

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SUMMARY

¶1. (SBU) On April 9, an IMF mission shared with donors its mostly positive assessment of Senegal's economy and the first review of Senegal's Policy Support Instrument (PSI). Mission head Johannes Mueller claimed that Senegal's GDP growth increased from 2.3 percent in 2006 to 4.8 percent in 2007, largely due to buoyant services and construction sectors, and despite a poor agricultural production. He stated that Senegal could achieve 5.5 to 6 percent growth in 2008 and sustain that level for the medium term. Much of this optimism is based on the assumption that the recapitalization of Senegal's industrial giant, ICS, will soon be concluded, resulting in significantly higher production and export of phosphates and related products. 2008 inflation should be around 4.5 percent, but could move down to historic levels of around 2 percent in the coming years.

¶2. (SBU) Mueller also emphasized the need for greatly increased fiscal discipline and transparency, and, due to a larger than expected budget deficit, the government needs to reduce expenditures while better focusing on priority sectors. Mueller was complimentary to the GOS for meeting the strict conditions laid out for starting the PSI, noting that problems revealed in the government's payment systems were likely due to a "misunderstanding." While recognizing progress made by the GOS in moving forward on the PSI, many donors expressed skepticism at the prospects for significant economic improvement in the coming year, citing in particular problems in the agriculture sector and the country's ability to head off significantly higher inflation. Donors also pointed out that even the optimistic economic assessment for Senegal in the medium term falls well below the country's stated goals as outlined in its much-touted Accelerated Growth Strategy (AGS). The team's concerns about the fiscal impacts of a new Special Economic Zone, were somewhat allayed. End Summary.

THE OPTIMISTIC IMF

¶3. (SBU) An IMF team visited Senegal March 25 through April 10 to review the country's economic performance and efforts to maintain progress on non-disbursing PSI, which was signed in November. IMF Team leader Johannes Mueller provided briefings to key donors at the beginning and end of the mission.

¶4. (SBU) In reviewing the state of the economy, Mueller found that 2007 had been reasonably good. He estimated real GDP growth for 2007 at 4.8 percent, while the inflation averaged 6 percent. For the medium term, starting 2008, Mueller predicted that GDP growth should be in a range of 5.5 to 6 percent, as a result of buoyant service and construction sectors, and the positive resumption of ICS's activities. Inflation is projected at 4.5 percent in 2008 and 2 percent for the medium term. Mueller also predicted that Senegal will be well positioned to mobilize increasing amounts of foreign direct investment. However he noted some risks associated with the international environment and the current turmoil in the financial markets. The IMF team downplayed the fact that it views the drivers of growth to be in the construction, public works, telecommunication, and transport sectors, but these are not the same sectors targeted by Senegal's AGS, which also hopes to achieve higher than 7 percent sustained growth.

¶5. (SBU) Mueller said that the external current account deficit will slightly deteriorate from 10 percent of GDP in 2007 to some 12 percent of GDP in the medium term. However Senegal's balance of payment deficit is expected to be covered by foreign direct investment, with a minimal impact of the country's debt sustainability. He noted that the fiscal deficit will be grow temporarily from 3.5% of GDP in 2007 to 4.8% in 2008 because of a previously unaccounted for stock of unpaid invoices and expected increases subsidies for key consumer goods. Mueller expressed the view that temporary subsidies are likely necessary for maintaining social stability, but that the IMF will monitor the evolution of subsidies closely to ensure the country's debt viability remains on track. Given these budget constraints, Mueller claimed that the IMF is pushing Senegal to find new avenues for reducing expenditures.

¶6. (SBU) Regarding Senegal's performance on meeting PSI "pre-conditionality," Mueller was very generous in his praise of the GOS's efforts, noting that it required a number of actions by the government before the end of 2007, all of which were achieved. He cited in particular the legislative steps required to change the

status of Senegal's investment promotion agency, APIX, to assure it remained fully controlled by the government. He explained that the government received a "pass" for its work on paying its arrears to private sector contractors, but that the IMF has recently become aware of another stock of past due invoices, which Mueller explained away as likely a "misunderstanding" by GOS officials on what the PSI required.

STILL MANY AREAS FOR IMPROVEMENT

¶7. (SBU) The IMF team outlined a series of priorities that Senegal needs to address:

-- speed the pace of reforms to improve the business environment, attract new domestic and foreign investment, and enhance competitiveness;

-- accelerate financial sector reforms in cooperation with the BCEAO and make operational the new framework for small and medium enterprises;

-- prioritize investment projects and increase spending on poverty reduction, health, education, and agricultural sectors, as well as improve the quality of those expenditures. (Mueller noted that in 2007 Senegal spent approximately 22 percent of its budget on "social needs," which was both low and not well targeted);

-- begin implementing a time-phased and gradual economic liberalization program in compliance with the European Union's proposed Economic Partnership Agreement;

-- limit subsidies to consumer goods and the energy sector to an amount not to exceed 0.5% of GDP. (In 2007, energy-sector subsidies were estimated at up to three percent of GDP);

-- consider a possible introduction of a social transfer mechanism (cash transfers) that appears to work in certain Latin American

countries, as a way to enable the poor to access to key social services.

DONORS NOT ENTIRELY CONVINCED

¶8. (SBU) Representatives from France, United Kingdom, Japan, Germany, Italy, Belgium, Switzerland, Canada, Holland, Spain, UNDP, The European Union, World Bank, African Development Bank, China, India, and the U.S. attended the briefings and highlighted a range of concerns, including late payments to the private sector, inflation pressures, food insecurity, a lawsuit by commercial creditors to contest the recapitalization plan for ICS, a bleak outlook for improved agriculture performance, and an overall insufficient commitment from the GOS to adequately coordinate and assure the best value for donor funds. Other issues the donors asked the IMF to follow up on included:

-- high protectionist taxes for some key consumer goods such as cooking oil and sugar, which are regressive with negative impacts on the poor. The tax on oil is estimated to increase the cost to the consumer by some 40%;

-- the need for prudence in light of the IMF's positive response to President Wade's goal of achieving self-sufficiency in rice production by 2015, which might not actually fall within the country's comparative advantage (especially given the limited amount of readily arable land in the country). There is also concern that donors have not yet received any GOS document detailing the government's plan to achieve this goal.

GOOD NEWS ON SPECIAL ECONOMIC ZONE

¶9. (SBU) The IMF team had previously expressed significant unease at the potential fiscal impact of the proposed Special Economic Zone to be funded by Dubai's Jafza International. Officials with the zone apparently presented the IMF with a comprehensive plan for distinguishing between foreign and domestic investment within the zone, and for companies seeking to only export and production for the local market. The zone will also be fully walled off with strict access control to minimize products slipping into a gray market.

COMMENT

¶10. (SBU) The donors greatly appreciated the IMF team's briefings but are not convinced by the IMF's generally positive assessment of Senegal's economic performance. Our impression is that the IMF wants very much for the GOS to succeed in this non-disbursing program since Senegal is one of the first countries in Africa to

sign a PSI, and it did so even though it probably could have benefited from another Poverty Reduction and Growth Strategy (PRGS) program. Praising the government for the "difficult" task of changing APIX's status is emblematic. There was not legislative opposition to the change, just a deep hesitancy by the government to make it happen. In fact the GOS waited until the last possible minutes of December 31, perhaps hoping the IMF would not insist on this requirement. By sticking to its guns on APIX, we hope the IMF has set the stage for helping the GOS live up to its commitments for deeper reforms.

SMITH